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TAGS: EFIN ECON ELAB PREL GM
SUBJECT: FINANCIAL CRISIS AND EASTERN EUROPE: PRIMARILY A
POLITICAL WORRY FOR GERMANY

REF: A. BERLIN 00354
¶B. BERLIN 00379

Classified By: EMIN ROBERT POLLARD FOR REASONS 1.4 (B) AND (D).

¶1. (C) SUMMARY. The German government is concerned about deteriorating conditions in Central and Eastern European (CEE) countries due to the financial crisis, but does not consider the potential for economic spill-over from east to west to be substantial. Of greater concern are the possible political repercussions of economic collapse in CEE countries, especially Ukraine, as weak conditions in Germany and other West European economies spread eastward. Foreign Minister Frank-Walter Steinmeier has created a new task force to examine the political implications of the financial crisis worldwide. Whether or not it proves effective -- it still has no staff or funds -- the task force provides a convenient forum for the Foreign Minister/Chancellor candidate to increase his profile on economic issues. END SUMMARY.

EASTERN HEADACHE

¶2. (SBU) German and international media are awash with stories of economic meltdown in Central and Eastern Europe (CEE), with dire consequences for western neighbors like Germany. One oft-cited fear concerns the exposure of German banks to affiliates in collapsing economies like Ukraine and Hungary. Other commentators stress the trade angle, and worry that weak eastern markets will hurt struggling western exporters. Especially after the resignation of Hungarian Prime Minister Ferenc Gyurcsany in March, anxiety over political instability in the CEE region has intensified. Is the hype warranted?

ECONOMIC CONCERNS OVERBLOWN

¶3. (C) Contacts at the Finance Ministry downplayed worries over economic conditions in most CEE countries. Dr. Franz Neueder of the European Financial and Economic Policy Division told Econoff that the economies of eurozone members Slovakia and Slovenia were stable, and that non-eurozone members Czech Republic and Poland were weathering the economic storm. Neueder said Bulgaria was also faring relatively well. In any event, weak conditions in the east were not having a significant impact on the German economy, he said. The Baltic countries were so small that any problems there were inconsequential for Germany. Should any German banks need fresh capital resulting from insolvencies

in CEE countries, Neueder explained, they could always tap into the government's bank rescue fund ("Soffin"). According to Dr. Andreas Niemann of the same office, there was actually a 50-60 billion euro capital inflow to the CEE region in 2008, and CEE banks were turning a profit.

¶4. (C) Neueder explained how Germany was helping stabilize CEE economies. "For the 12 'new' EU countries," he said, "there are some 40 billion euros of structural funds every year." Neueder also noted the recent agreement to double the EU's balance of payment (BOP) facility for non-eurozone EU members to 50 billion euros; the European Investment Bank and European Bank for Reconstruction and Development were also important contributors for EU countries. Neueder dismissed the possibility of speeding up entry into the eurozone to help stabilize non-eurozone economies. Outside the EU in countries like Ukraine, the IMF should play the major role, he said. Neueder thought the United States should "use its influence to make sure the IMF gets help to the countries that need it."

DECOUPLING REVISITED

¶5. (SBU) Economist Ognian Hishow of the German Institute for International and Security Affairs (SWP) agreed that spill-over from CEE economies was unlikely to have a major impact on Germany. Germany's financial and trading links to the CEE region had grown since reunification, but were small in comparison with traditional partners in Western Europe. According to the Bank for International Settlements (BIS),

German banks have around 200 billion euros of exposure to "emerging Europe," representing around 6.5 percent of Germany GDP. In the CEE region nearly half of all German banks' claims are in just two countries -- Poland and Russia. While around 16 percent of Germany's total exports went to the CEE region in 2008, according to the Federal Statistical Office, Poland is the only country in the region in the top 10, taking just over 40 billion euros worth of German goods and services last year (4 percent of Germany's total exports). Russia and Czech Republic are the next two most important CEE export destinations.

¶6. (SBU) Moreover, some CEE countries are faring better than others. "Ukraine is in particularly bad shape," Hishow told us, adding that Hungary, Romania and Latvia had "received a lot of attention because of their IMF bailouts." Hishow thought other CEE countries like Poland and the Czech Republic, where Germany's ties were more important, were faring much better. Even Russia stands apart, he explained, as it has been a capital-exporting country rather than a capital-importing country like Hungary. Hungary will undergo a much more traumatic unwinding of its imbalances. "But forget about CEE countries," offered Hishow. "The country I'm worried about is Spain."

GERMANY AS THE PROBLEM

¶7. (C) Officials from the German Foreign Ministry told us they were indeed concerned about the situation in CEE countries, but not about the direct economic impact on Germany. Instead, the worry runs the other way. Frank Hartmann of the Central Europe and the Benelux Countries Division, told Econoff that the recession in Western Europe -- and of Germany, in particular -- was pulling down eastern economies. Citing HypoVereinsbank (HVB) as an example, Hartmann said certain west European banks were withdrawing capital from CEE affiliates to deal with their own liquidity needs. At the same time, the drop-off in demand from west European trading partners, especially Germany, had been devastating for CEE exporters.

¶8. (C) Hartmann's description matches the data. According to

the ratings agency Fitch, "EU-15" imports dropped 9.3 percent in the 4th quarter of 2008, which slammed CEE exporters. This decline has been wrenching: goods exports are 79 percent of GDP in Slovakia, 70 percent in the Czech Republic, and 68 percent in Hungary. Hartmann noted one bright spot: the Czech Republic had benefitted from a provision in the German stimulus package known as the "wrecking premium," whereby the government gives drivers a 2,500 euro subsidy for trading in their old car for a new one. Czech car producers like Skoda were increasing exports to Germany, he said. Otherwise, the outlook was bleak.

UKRAINE IN CLASS BY ITSELF

¶9. (C) In fact, there are two groups of CEE countries within the EU, explained Ole Funke of the EU Economic and Financial Policy Division, Ministry of Foreign Affairs: 1) countries like Poland, Czech Republic, and Slovakia who -- thanks to eurozone convergence criteria or membership -- had undertaken macroeconomic reforms that were now ensuring their stability; and 2) countries like Hungary, Latvia and Romania that were in pretty serious trouble. He added that non-EU member Ukraine was in a category all by itself.

¶10. (C) Funke told us the Ministry of Foreign Affairs had recently set up an internal task force to look at political implications of the financial crisis worldwide (ref A), and that Ukraine was of particular concern. Hartmann added that several negative factors -- dysfunctional political rivalries, tensions over energy with Russia, and desperate economic conditions -- had converged to make the situation there highly uncertain. (COMMENT: As reported ref B, there is wide-spread concern in the German government that the situation in Ukraine has become so bad that the entire system -- economic and political -- could be at risk. END COMMENT.) Hartmann said the German government hoped Ukraine could soon receive the second tranche of IMF assistance, though the

Rada's failure to place bills on pensions and Naftohaz budget reform on the legislative agenda was a clear setback. Otherwise, the new task force has not yet put forward any concrete proposals.

COMMENT

¶11. (C) German government officials clearly do not regard weakness in CEE economies as a direct problem for the German economy. Still, they are concerned that as conditions continue to slide, the political consequences could become more serious. Ukraine, and to a lesser extent Hungary, seem to be among the biggest worries. The overriding strategy for now is to help CEE countries through the rough times by providing funds through the IMF, EU and other multilateral channels. Ultimately, Germany's own economic recovery will be the key factor in putting CEE economies back on the track. For all the recent attention in the press, the new Foreign Ministry task force on the implications of the financial crisis has no permanent staff, no funds, and has not commissioned any papers. Its creation may be in part an attempt by Chancellor-candidate Steinmeier to raise his profile on the financial and economic crises. At the very least, creating the task force within his own Ministry will ensure he is not caught off-guard in the event of any sudden political developments triggered by the crisis.
Koenig